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JAPAN AND MERGERS: OIL AND WATER?

Summary

Mergers and acquisitions certainly are not new phenomena in the corporate worlds of either America or Japan. The 1980s ushered in a new era in the United States when a fearless attitude toward debt financing spawned megadeals. The profit potential of leveraged buyouts did not escape Japanese financial institutions. Japanese manufacturers also recognized that takeovers offered them a quick way to establish a foreign production base and/or to diversify. At the beginning of the 1990s the Japanese are poised to become major global M&A players. While this may seem a natural development for a country with the world's largest banks, brokerage houses and insurers, it represents a significant shift in viewpoint for the Japanese.

The reasons behind changing Japanese attitudes toward mergers and acquisitions, both at home and abroad, are varied. Nevertheless, companies and investors more and more are incorporating M&A into their strategies in response to changing economic and social conditions. The still nascent shift in Japanese attitudes could evolve in many directions, but some patterns already are visible.

Overview

It is a common American belief that mergers and acquisitions are rare creatures in Japan's business world, particularly if either involves a foreign suitor. Until 1980 Japanese foreign exchange regulations were major obstacles to foreign firms interested in buying an existing Japanese company. Even after

legal reforms that year substantially eliminated these barriers, foreign investors ran afoul of traditional business practices that are at least as formidable. A record of failure for foreign takeover attempts in the postwar era spread the perception that mergers and acquisitions are not welcome in Japan.

According to statistics compiled by Japan's Fair Trade Commission, however, not only does domestic M&A activity have a healthy record but it also is rising. From an overall standpoint, the data show that the Japanese M&A market has become roughly comparable to its American counterpart in terms of activity but lags significantly in terms of value (see Tables 1 and 2). In the 1960s and 1970s mergers and acquisitions in Japan were less than half the American count. That changed rapidly in the 1980s as the number of both grew. It is clear, however, that acquisitions occur far less frequently than mergers.

The total value of Japan's M&A market, although it advanced in step with increased activity, still is relatively small compared to the U.S. market. A comparison of the number of large M&A deals in each country points to even more disparity. Deals worth more than $100 million grew rapidly in the United States during the 1980s. While the number of big Japanese deals -- defined as Y50 billion ($333 million at Y150=$1.00) or more -- also expanded during this period, the total remained well below the U.S. level.

Most of the M&A activity in Japan takes place among firms capitalized at less than Y500 million ($3.3 million). Tables 3 and 4 show that companies of this size and smaller accounted for over 90 percent of all mergers and 88 percent of all acquisitions in FY 1988. There is a clear dichotomy in M&A behavior between small and large Japanese firms. Although this same phenomenon also is generally true in the United States, the break is sharper in Japan where large Japanese firms may use their cross-stockholdings (discussed below) as a highly effective defense against unwanted overtures.

An analysis by industry shows several contrasts between the two countries (see Tables 5-7). The different structure of the American and the Japanese oil industries, for example, causes great disparity in the data. Although large firms dominate the business in both countries, the host of small U.S. companies has no equivalent in Japan. In the 1980s the American oil industry underwent a severe shakeout; the Japanese industry was quiet. A shakeout also went on during this period among American financial institutions, a trend not mirrored in Japan. (Tokyo's continuing program of financial reform may lead to changes in the 1990s, however.) In addition, there was considerable activity in the wholesale/retail trade industries of both countries, which was not surprising given the volatile nature of the business. Unfortunately, U.S. statistics bury information about the manufacturing sector within the "Other" category. According to Japanese data, there has been a clear upturn in M&A activity in the manufacturing sector, with firms that make electric and nonelectric machinery as well as chemical manufacturers showing the clearest trend.

Statistics on foreign M&A activity in the United States and Japan (see Tables 8 and 9) lend weight to foreign concerns about the openness of the Japanese M&A market since the data indicate foreign activity is far greater in

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Table 1: U.S. Merger and Acquisition Activity, 1970-87

	1970	1980	1981	1982	1983	1984	1985	1986	1987
Mergers and Acquisitions (number)	5,152	1,889	2,395	2,346	2,533	2,543	3,001	3,336	2,032
Value (billions)	$16.4	$44.3	$82.6	$53.8	$73.1	$122.2	$179.8	$173.1	$163.7
$100 Million-Plus Deals (number)	10	94	113	116	138	200	270	346	301

Source: W.T. Grimm & Co. as cited in Department of Commerce, Statistical Abstract of the United States.

Table 2: Japanese Merger and Acquisition Activity, FY 1970-FY 1988

	FY 1970	FY 1980	FY 1981	FY 1982	FY 1983	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Mergers (number)	1,147	961	1,044	1,040	1,020	1,096	1,113	1,147	1,215	1,336
Value (billions)	n.a.	n.a.	Y1,960.3	Y2,884.7	Y1,676.6	Y1,918.4	Y3,120.9	Y4,366.6	Y3,198.8	Y3,349.9
Y50 Billion-Plus Deals (number)	n.a.	n.a.	24	5	33	33	26	40	53	51
Acquisitions (number)	413	680	771	815	702	790	807	936	1,084	1,028
Value (billions)	n.a.	n.a.	Y274.9	Y433.8	Y426.8	Y554.1	Y449.5	Y219.5	Y267.4	Y130.0
Y50 Billion-Plus Deals (number)	n.a.	n.a.	26	42	30	48	53	72	78	66

Note: Y50 billion is approximately $333 million at Y150=$1.00.

Source: Fair Trade Commission

Table 3: Japanese Mergers by Size of Firm, FY 1975-FY 1988

(number of announced mergers; capital in millions of yen)

Fiscal Year	Under Y10	Y10-Y49	Y50-Y99	Y100-Y499	Y500-Y999	Y1,000-Y4,999	Y5,000-Y9,999	Over Y10,000
1975	241	426	109	128	14	24	6	6
1976	211	441	111	119	27	27	1	4
1977	211	446	124	164	29	29	5	3
1978	179	365	113	158	51	26	4	2
1979	177	265	205	153	33	28	3	7
1980	192	433	108	158	37	22	6	5
1981	173	424	162	198	43	36	4	4
1982	177	492	144	140	40	35	4	8
1983	157	432	175	184	24	30	10	8
1984	197	482	177	174	19	34	6	7
1985	203	440	231	162	29	33	7	8
1986	206	472	213	167	37	31	12	9
1987	174	491	203	226	42	51	12	16
1988	182	509	250	286	33	48	18	10

Source: Fair Trade Commission

Table 4: Japanese Acquisitions by Size of Firm, FY 1975-FY 1988

(number of announced acquisitions; capital in millions of yen)

Fiscal Year	Under Y10	Y10-Y49	Y50-Y99	Y100-Y499	Y500-Y999	Y1,000-Y4,999	Y5,000-Y9,999	Over Y10,000
1975	117	158	49	53	9	30	0	13
1976	116	209	73	61	13	24	4	11
1977	123	243	89	104	17	50	6	14
1978	140	222	80	91	16	24	5	17
1979	118	262	74	83	26	30	5	13
1980	114	292	86	93	12	25	13	15
1981	137	350	112	96	23	36	7	10
1982	158	322	109	132	24	38	5	27
1983	133	266	115	115	16	31	10	16
1984	129	304	134	158	6	22	10	27
1985	125	290	129	155	24	51	7	26
1986	168	360	124	158	24	48	10	44
1987	168	422	162	205	17	45	11	54
1988	173	391	145	197	11	52	9	50

Source: Fair Trade Commission

the United States than in Japan. While the number of foreign buyers in the United States has increased since 1981, their number is not far out of line with 1980 and 1981 levels. The number of foreign sellers in the United States shows even less of a pattern. In Japan foreign-initiated bids begin to drift

Table 5: U.S. Mergers and Acquisitions by Industry, 1983-87

Number

Industry	1983	1984	1985	1986	1987
Oil and Gas	111	102	86	58	30
Banking and Finance	331	251	381	415	262
Insurance	67	66	67	94	38
Mining and Minerals	18	12	16	14	8
Food Processing	74	58	82	101	78
Conglomerates	13	18	14	20	6
Transportation	36	36	48	58	34
Broadcasting	60	83	93	123	64
Retail	90	130	136	147	150
Brokerage/Investment Firms	63	86	49	47	32
Other	1,670	1,701	2,029	2,259	1,330
Total	2,533	2,543	3,001	3,336	2,032

Value (millions of dollars)

Industry	1983	1984	1985	1986	1987
Oil and Gas	$12,076	$42,982	$23,160	$3,247	$15,442
Banking and Finance	13,628	5,846	14,037	19,442	16,209
Insurance	2,966	3,006	2,694	5,413	2,484
Mining and Minerals	2,946	347	356	148	676
Food Processing	1,164	7,195	11,838	4,707	3,316
Conglomerates	2,745	6,983	16,302	15,307	6,839
Transportation	5,255	1,252	2,877	6,829	4,956
Broadcasting	3,747	1,918	15,013	8,407	8,729
Retail	1,489	6,673	10,030	13,683	17,039
Brokerage/Investment Firms	1,455	1,460	579	1,710	3,492
Other	25,609	44,662	82,882	94,544	84,504
Total	73,080	122,324	179,768	173,437	163,686

Source: W.T. Grimm & Co. as cited in Department of Commerce, Statistical Abstract of the United States.

lower in 1985, but this is somewhat deceptive since the value of such transactions has grown in recent years. Overseas bids by Japanese firms have shown the strongest growth in both number and value, particularly since 1987.

A Different View of M&A

The statistics clearly show that Japan's M&A market has become as robust as the American one in some ways but is significantly noncomparable in others. Differences stem from each country's laws, economic structures, business practices and social attitudes.

- Legal environment - As mentioned previously, prior to 1980 Japan's Foreign Exchange Control Law served as an effective gate, allowing inward and

Table 6: Japanese Mergers by Industry, FY 1984-FY 1988

Number

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Forestry and Fishing	6	6	9	2	7
Mining	2	3	3	6	3
Construction	89	63	60	61	64
Manufacturing	237	221	243	268	291
Food	22	30	24	22	32
Textiles	29	26	15	23	26
Wood Products	18	10	7	14	8
Paper and Pulp	8	11	8	5	9
Publishing and Printing	14	14	10	14	23
Chemicals, Oil and Coal	31	15	34	36	31
Rubber and Leather	4	4	3	3	4
Nonmetallic Minerals	10	15	18	15	14
Steel	10	4	10	7	7
Nonferrous Metals	9	1	5	6	4
Fabricated Metal Products	10	14	26	22	15
Nonelectric Machinery	29	29	15	32	30
Electric Machinery	21	23	32	35	48
Transportation Equipment	7	7	15	12	15
Precision Equipment	9	11	12	7	6
Other	6	7	9	12	19
Wholesale and Retail Trade	377	408	398	409	460
Real Estate	115	104	120	140	143
Transportation and Communications	58	66	50	69	70
Services	106	130	151	142	167
Finance and Insurance	42	30	34	21	19
Electricity and Gas	0	2	1	0	1
Other	64	80	78	97	111
Total	1,096	1,113	1,147	1,215	1,336

Value (billions of yen)

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Forestry and Fishing	Y2.3	Y4.1	Y7.0	Y1.1	Y4.7
Mining	6.8	0.5	0.2	0.3	40.0
Construction	44.6	61.9	36.4	72.7	44.8
Manufacturing	258.9	625.2	1,156.8	1,108.5	528.8
Food	36.0	102.1	8.5	44.7	59.0
Textiles	19.0	30.6	3.5	106.5	36.5
Wood Products	4.9	5.6	0.5	3.9	6.3
Paper and Pulp	11.0	75.1	22.4	3.1	53.6
Publishing and Printing	4.1	28.9	2.9	21.3	20.7
Chemicals, Oil and Coal	23.3	134.0	434.7	92.1	98.8
Rubber and Leather	2.4	17.2	0.3	2.6	1.2
Nonmetallic Minerals	10.3	9.8	16.6	8.6	13.1
Steel	9.6	14.5	16.7	78.2	12.0
Nonferrous Metals	61.5	0.1	55.1	14.2	39.1

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Fabricated Metal Products	3.9	4.3	21.9	31.4	84.0
Nonelectric Machinery	32.6	51.5	12.7	89.9	21.5
Electric Machinery	19.7	14.9	512.1	346.0	36.7
Transportation Equipment	2.8	1.7	26.9	248.7	16.5
Precision Equipment	13.6	132.9	19.6	9.0	10.2
Other	4.3	2.0	2.3	8.3	19.4
Wholesale and Retail Trade	880.6	1,885.5	541.6	845.2	935.0
Real Estate	183.2	224.0	447.7	496.5	680.3
Transportation and Communications	29.3	100.3	153.1	53.7	148.4
Services	248.2	102.0	135.3	166.3	106.7
Finance and Insurance	245.8	44.5	1,848.5	182.4	377.4
Electricity and Gas	0.0	0.7	0.0*	0.0	0.2
Other	18.7	72.2	40.0	272.1	483.6
Total	1,918.4	3,120.9	4,366.6	3,198.8	3,349.9

*Less than Y0.1 billion.

Source: Fair Trade Commission

Table 7: Japanese Acquisitions by Industry, FY 1984-FY 1988

Number

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Forestry and Fishing	3	0	1	2	2
Mining	1	2	3	1	0
Construction	17	11	19	23	21
Manufacturing	76	68	83	94	99
Food	6	8	10	6	12
Textiles	1	7	1	8	5
Wood Products	8	9	11	1	3
Paper and Pulp	2	3	1	3	2
Publishing and Printing	3	1	2	4	5
Chemicals, Oil and Coal	15	8	17	15	22
Rubber and Leather	2	2	1	1	0
Nonmetallic Minerals	9	6	7	7	5
Steel	3	2	2	5	1
Nonferrous Metals	7	1	0	4	1
Fabricated Metal Products	3	7	4	3	2
Nonelectric Machinery	5	5	10	12	8
Electric Machinery	2	3	11	14	15
Transportation Equipment	4	3	3	5	6
Precision Equipment	0	2	1	3	9
Other	6	1	2	3	3
Wholesale and Retail Trade	135	161	171	179	167
Real Estate	9	4	11	11	8
Transportation and Communications	62	49	51	70	67
Services	22	34	29	38	43

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Finance and Insurance	15	16	32	21	28
Electricity and Gas	1	1	0	2	0
Other	449	461	536	643	593
Total	790	807	936	1,084	1,028

Value (billions of yen)

Industry	FY 1984	FY 1985	FY 1986	FY 1987	FY 1988
Forestry and Fishing	Y1.1	Y0.0	Y0.0*	Y0.0*	Y0.0*
Mining	0.4	7.0	0.1	0.0*	0.0
Construction	1.0	0.5	1.0	3.9	0.1
Manufacturing	332.2	49.3	29.3	52.1	15.1
Food	6.6	2.3	0.2	1.8	1.2
Textiles	1.7	0.8	9.3	1.1	3.0
Wood Products	0.0*	0.3	0.1	0.0	0.0*
Paper and Pulp	2.4	1.2	0.3	0.0	0.0
Publishing and Printing	0.0	0.1	0.0*	8.0	0.1
Chemicals, Oil and Coal	304.1	34.1	7.3	5.1	3.0
Rubber and Leather	0.5	0.0*	0.0	0.4	0.0
Nonmetallic Minerals	4.9	0.4	1.2	0.6	0.2
Steel	1.6	0.0*	0.1	14.6	0.0
Nonferrous Metals	5.6	0.8	0.0	0.5	3.5
Fabricated Metal Products	0.7	1.1	0.0	0.7	0.0*
Nonelectric Machinery	0.1	1.5	1.2	8.0	2.4
Electric Machinery	0.1	5.8	9.5	8.6	1.6
Transportation Equipment	1.2	0.8	0.1	0.5	0.0*
Precision Equipment	0.0	0.0*	0.0	0.1	0.0*
Other	2.7	0.0*	0.0*	2.1	0.0
Wholesale and Retail Trade	75.4	327.8	46.0	37.3	13.2
Real Estate	0.1	4.0	0.3	4.8	0.6
Transportation and Communications	9.8	15.1	3.4	4.5	3.8
Services	7.0	12.9	4.5	29.9	2.9
Finance and Insurance	36.0	11.6	32.7	56.5	7.6
Electricity and Gas	4.3	7.3	0.0	0.1	0.0
Other	86.8	14.1	101.9	78.4.	86.6
Total	554.1	449.6	219.5	267.4	129.9

*Less than Y0.1 billion.

Source: Fair Trade Commission

outward direct investment only with the government's permission. From 1950 to the mid-1960s foreign direct investments, whether new investments or takeovers, were approved only after careful scrutiny. When Japan joined the Organization for Economic Cooperation and Development in 1964, Tokyo was forced to weaken its control over the convertibility of the yen. Fearing a wave of foreign takeovers, bureaucrats took a very hard-nosed attitude toward foreign interest in domestic firms, sparingly approving any foreign investment applications. This

Table 8: Japanese Merger and Acquisition Announcements, 1984-89

(number of announced transactions)

	1984	1985	1986	1987	1988	1989
Japanese Purchases of Japanese Firms	140	163	226	219	223	240
Japanese Purchases of Foreign Firms	44	100	204	228	315	404
Foreign Purchases of Japanese Firms	6	26	21	22	19	17
Total	190	289	451	469	557	661

Source: Yamaichi Securities Co., Ltd.

Table 9: Foreign Mergers and Acquisitions in the United States, 1982-87

(number of announced transactions)

	1982	1983	1984	1985	1986	1987
Foreign Sellers	121	146	147	175	180	142
Foreign Buyers	154	125	151	197	264	220

Source: W.T. Grimm & Co. as cited in Department of Commerce, Statistical Abstract of the United States.

rigid stance eased gradually through the 1970s as Tokyo slowly brought its regulations on external financial flows into line with OECD guidelines. But even after 1980, when both inward and outward foreign investment was made free in principle, the lack of transparent procedures and some residual restrictions daunted most foreign investors in Japan. In short, mergers and acquisitions involving foreign suitors have received little official encouragement -- and much discouragement -- during most of Japan's postwar era.

Domestic companies interested in mergers also faced major governmental hurdles. Tokyo made rebuilding the economy the nation's top priority; scarce savings were channeled into the creation and expansion of economic infrastructure and private plant and equipment. All other activities, such as acquisitions and consumer finance, were deprived of capital. Japanese companies interested in M&A could not avoid Tokyo's wishes because domestic financial markets had no structures to accommodate them and were completely under the government's thumb.

- Economic factors - Japan's economic miracle provided a comparatively barren soil for mergers and acquisitions by eliminating major motivations for choosing this path. Strong economic growth lowers the rate of bankruptcy and, therefore, mergers, which often are used to stave off bankruptcy. Strong economic growth also provides ample opportunities for expansion, making growth by acquisition unnecessary.

• Corporate relations - Japanese businesses often hold some of each other's equity as a symbol of their business ties. These shares are not sold as long as the partnership lasts. Although only a token amount most often is involved, a single company with many business relationships can have a significant amount of such goodwill stock. In cases where a firm depends a great deal on another company, a substantial portion of the dependent firm's stock often is held by the other business. A classic example is the Japanese automotive industry where the top firms, such as Toyota Motor Corp. or Nissan Motor Co., Ltd., often have representatives on the boards of subcontractors and parts suppliers by virtue of cross-stockholdings. In addition, until recently banks required matching collateral from borrowers before making a loan; many firms fulfilled this commitment with their shares, further decreasing the percentage of stock available to the public. Finally, several groups of Japanese firms are linked through stockholdings and business dealings. Although the cohesiveness of these keiretsu is slowly eroding (see JEI Report No. 2A, January 12, 1990), their tradition of cross-shareholding makes members resistant to takeover bids.

Although not the same as cross-stockholding, the investment strategies of insurance companies and trust/pension fund managers also reduce the pool of publicly traded shares. Because these firms are interested in long-term dividend income, they tend to hold shares rather than actively trade them. These institutional investors form an important part of a company's "stable shareholders" that actively and closely consult with the firm's management. Not only do these stable shareholders help the firm with its long-term development, but they also can play a decisive role in defeating hostile takeover bids. At the same time, though, they can put great pressure on management to accede to a merger or an acquisition if they feel it is in their best interest.

Both cross-stockholding and stable shareholding sharply reduce the percentage of a company's shares traded on the open market. In many cases these two groups constitute at least two-thirds of a firm's shareholders. This has proved to be an extremely effective defense against hostile bids. This defense evolved partly because Japanese laws bar a holding company structure, a common takeover barrier in the United States.

These stockholding patterns have not prevented stock speculators from prospering in Japan. In fact, "greenmail" -- forcing a company to pay inflated prices to buy back shares that were covertly purchased by a hostile outsider -- is well-entrenched in Japan. Although greenmailers have a distasteful image among mainstream businesses, Tokyo has done little to stamp them out.

• Social attitudes - Although a nebulous factor, cultural views nonetheless have very effectively helped to deter the introduction of American-style mergers and acquisitions in Japan. Japanese society is organized around groups, not individuals, and the company occupies a position near the top of society's hierarchy. To Japanese managers and employees a company is a living social unit, sometimes more important than the family, and can command a high degree of employee loyalty and management paternalism. Buying and selling companies based solely on financial considerations runs counter to this viewpoint, and sentiment against a takeover bid can be intensely personal. Even when a merger is friendly, the two firms often have great difficulty integrating because loyalties are extremely difficult to transfer (see, for example, JEI Report No. 35B, September 15, 1989).

Americans long have accepted mergers and acquisitions as a legitimate tool to grow and/or diversify. This tradition is not only weak in Japan but an opposing viewpoint actually is more prevalent. Merging is seen as a last resort to avoid bankruptcy, as mentioned above. Accepting a merger or an acquisition proposal is tantamount to announcing publicly that management has failed to do its job. To the intensely competitive Japanese, this is a form of surrender. The Japanese reaction to the purchase of Sansui Electric Co., Ltd. by Britain's Polly Peck International (Holdings) BV, for example, stressed the weakened condition of the electronics company rather than the opportunities for globalization.

Finally, American manufacturers and financial firms focus almost solely on the bottom line when evaluating corporate strategies. The American M&A market boomed in the 1980s because it was highly lucrative to all parties involved. Anything that made money seemed then to be acceptable to American businessmen. Japanese business has criticized this "money chasing money" attitude severely. Making products traditionally is the unchangeable first order of business. Unless the situation were dire, a respectable Japanese manager would not even consider M&A as part of his business plan.

All these factors combined to make mergers and acquisitions legally difficult and socially distasteful in Japan up until the 1980s. It is no surprise that foreigners interested in M&A as an entree to Japan's markets met with little success.

A Changing View

Beginning in 1980, however, significant shifts in all of the above mentioned factors plus other new developments forced Japanese corporate planners to reevaluate M&A.

- Legal environment - The 1980 revision of the Foreign Exchange Control Law reversed, in de jure terms at least, Tokyo's treatment of foreign direct investment, both inward and outward. Such transactions became "free in principle" with restrictions applying only in special cases for investments in Japan. Until 1984, however, the scope of "special cases" was so broad that the old and the new foreign exchange regulations differed little with regard to foreigners hoping to purchase a Japanese firm.

In May 1984 the United States and Japan concluded an agreement that still reverberates today. The report of the Joint Japan-U.S. Ad Hoc Group on Yen/Dollar Exchange Rate, Financial and Capital Market Issues set Tokyo on a path of financial liberalization that included easing foreign exchange and foreign direct investment rules. The cumulative impact of this pact, known as the yen-dollar accord, has been to allow foreigners to invest in all but a handful of domestic firms (mainly those considered vital to national security), to make government approval of inward foreign direct investment applications automatic in most cases, and to make the approval process more transparent if foreigners encounter difficulties.

One direct consequence of Tokyo's financial market reforms is to make mergers in the banking sector much more likely in the coming years. A plan by the Ministry of Finance to eliminate gradually the regulations that now prevent head-to-head competition by different categories of banks is forcing smaller

banks to explore mergers to compete and is generating interest in acquisitions among larger banks interested in quick expansion. MOF's effort to allow banks and securities firms to compete directly against each other in certain markets as well as to give nonbank financial institutions greater leeway to enter new markets presages a shakeout in Japan's financial sector in which M&A will play a major role.

From a broader standpoint the liberalization and deregulation of Japan's financial markets has put new pressures on businesses and investors, particularly by making available instruments that yield comparatively high returns and by opening new opportunities for foreigners and Japanese alike. With savers demanding a higher return on their money, borrowers must pay greater attention to short-term profits instead of accepting a meager present return in hopes of long-term profits. Access to funding sources not controlled by the government has given Japanese and foreign firms the freedom to use the money in ways that bureaucrats may not approve, including mergers and acquisitions.

• Economic factors - Although the Japanese economy still outperforms its Western peers in terms of the inflation-adjusted annual growth of gross national product, its average performance in the 1980s (under 5 percent a year) was below the levels of the 1960s (around 10 percent) and 1970s (just above 5 percent). Besides raising the chances of bankruptcies (and therefore mergers), slower growth coupled with greater pressure to produce profits has forced Japanese management to consider all business options, even M&A.

The yen's appreciation against the dollar and other currencies between 1985 and 1988 combined with Tokyo's desire to emphasize the role of domestic demand to power growth have led to an on-going restructuring of the domestic economy. According to Japan's Fair Trade Commission, consolidation and reorganization of subsidiaries is one factor behind the jump in domestic mergers in the past few years. The yen's rise also has added pressure to pursue M&A in two other ways; a stronger yen has cut Japan's international competitive position but reduced the apparent cost of foreign assets. The frantic response by Japanese businessmen to the negative impact of the yen's rise is a major factor behind their reassessment of M&A. Given the yen's rapid ascent, Japanese corporations did not always feel they had the luxury of diversifying or building an overseas presence from scratch. Purchasing an existing firm provided instant relief. The enhanced overseas buying power of the yen made foreign mergers and acquisitions a very sound move from a financial standpoint.

• Corporate ties - Although no one expects the practice to be eradicated, the tradition of cross-stockholding is eroding a bit in Japan. Heightened pressure to generate profits has hardened banks' attitudes toward longtime corporate clients seeking the best possible deal on a loan. Banks also have been tempted to sell some of their vast stockholdings to boost profits, a maneuver that would have been unthinkable 10 years ago. More intense competition also is driving wedges between traditional business partners in some cases, again weakening the underlying reason for cross-stockholding.

The nascent Japanese debate over stockholder rights adds another wrinkle. Japanese corporations traditionally have paid low dividends, arguing that stockholders would benefit most from reinvestment of profits leading to long-term capital gains. Small shareholders were expected to be silent partners, never questioning management decisions or demanding bigger dividends. Defensive

moves by two Japanese department stores in 1989 against a merger proposed by a major stockholder shattered this complacency. The merger targets sold each other newly issued shares to thwart the outsider. Since the share prices were unrealistically low, a court ruled that the defense ran counter to the interests of stockholders and was illegal. The unprecedented decision may mark the beginning of a shareholders' rights movement in Japan, a development that could break the Japanese M&A market wide open.

- Social factors - Changes in regulatory and economic factors are being reflected in slowly shifting attitudes about M&A. Although the Japanese phrase for takeover bid also can mean "hijack," mergers and acquisitions are shedding their unfavorable image. This applies particularly to large Japanese companies that are becoming true multinational corporations. M&A is an accepted practice outside Japan, and Japanese businesses realize they would be handicapping themselves if they did not include it in their global business plans. Nevertheless, Japanese corporate executives are approaching overseas M&A in their own way, focusing on friendly takeovers. Only a few Japanese companies have attempted or succeeded in launching a hostile bid overseas.

At home the attitude toward M&A is changing very slowly. Company loyalty has taken a beating as personal fulfillment and concern over the quality of life have increased in importance, weakening antitakeover sentiment. The Japanese also are losing their distaste for making money by financial wheeling and dealing, thanks in part to the stock market's boom through 1989 and the surge in real estate prices. Hard-nosed financial management is accepted as a component of a successful business strategy, although pure speculation still is viewed as unhealthy. These changes hardly represent a revolution, but they do show that change is taking place.

Another Arrow in Japan's Quiver?

The integration of the Japanese economy into the global market has raised the competitive pressure on Japanese companies. As more companies are discovering, mergers and acquisitions are powerful additions to their box of business tools.

Japanese M&A activity in the United States arises from three different motives:

- Building a local presence - To reduce reliance on exports (and the associated trade frictions) and to overcome the negative effects of the yen's appreciation, Japanese companies have embarked on a drive to localize production around the world. Whether a firm wishes to remain within its traditional line of business or is interested in diversifying, M&A offers quick results. Aided by the openness of publicly traded American companies and by the shortage of savings, which affects all firms private or public, Japanese companies have found willing sellers in the United States.

- Boosting profits - Japanese lenders have eyed hungrily the comparatively rich returns that M&A can generate. Hesitant at first, Japanese lenders with their large capital resources have become key elements in American megadeals. Such passive participation appeals to risk-averse Japanese fund managers with little experience in M&A. As their familiarity with the product and the process grows, however, Japanese lenders increasingly will seek out M&A opportunities.

• Gaining experience - Japanese banks and securities firms are not only interested in providing the funding for American M&A deals but are keenly interested in learning how to manage such transactions. Major Japanese banks and brokerage houses have established ties to American M&A specialists both to learn about the U.S. market and to bring this American expertise to the Japanese market. Some pessimists are worried that Japanese entrants will usurp the leading M&A position of American firms, a fear Japanese companies are trying to allay by focusing on building long-term cooperative relations with their U.S. partners.

Although they have learned much, Japanese businesses cannot yet match the dealmaking prowess of American advisers. This is clear in Europe, where an M&A boom is in progress in advance of the European Community's plan to integrate its member economies more fully beginning in 1992. European firms have sought out American advisers both to pursue and defend against this wave of mergers and acquisitions. A few Japanese companies are interested in using M&A to gain a foothold on the continent before 1992 but are daunted by their lack of familiarity (compared to the United States) with the European market.

Lost in the debate over the magnitude of Japanese M&A activity is whether the approach will really benefit Japanese companies. While providing an instant presence, M&A has drawbacks that pose totally new challenges to Japanese managers. There is no guarantee, for example, that the foreign acquisition will prosper under Japanese management. This is a particular problem for Japanese firms using M&A to diversify. Keeping the previous local management may forestall immediate chaos but also may prevent necessary changes from being implemented. A more serious task is to successfully integrate the acquisition into the parent company. Because the head office is half a world away and using a different language, integration is proving very difficult. American employees can feel left out of major decisions or limited in terms of career advancement. Japanese staff do not always become active members of the local community.

Failure to address these issues combined with the sharp growth of Japanese mergers and acquisitions in the United States has generated an unexpected backlash from Americans against Japan. Quite correctly, Japanese corporate executives point out that they are not the only ones buying American companies and are not even the largest owners of U.S. firms. American fears are not rational but cannot be ignored. This psychological issue may be the most difficult to solve.

Outlook

The American uproar over "aggressive" Japanese takeover activity has made Japanese businessmen much more cautious about making highly visible investments in the United States. In addition, the American market for high-risk bonds issued to finance leveraged buyouts (junk bonds) has run into a few highly visible failures that have put a damper on M&A activities. The slowing U.S. economy also has an effect on the growth potential of an increasing number of firms involved in LBOs in the 1980s. These negative factors should slow Japanese financing of M&A activity in the United States.

Nevertheless, continuously growing demands for capital by U.S. companies will force American managers to keep an open mind about overtures from Japan. The current negative atmosphere is daunting but will not stop Japanese corporations from pursuing plans to localize production to service overseas markets

and to diversify abroad. Japanese companies are likely to focus more than ever on friendly takeovers. Whether Americans like it or not, the two economies will become ever more intertwined, and mergers and acquisitions will be an important vehicle of change.

M&A in Japan faces a more uncertain future. While the Ministry of Finance has initiated some steps that give takeover bids a greater chance of succeeding and is exploring other measures, many barriers lie outside of the government's reach. Cross-shareholding, a disregard for shareholders' rights and continued social denigration of mergers and acquisitions make it very unlikely that Japan will ever have a freewheeling M&A market. For the most part this suits the Japanese business community fine since it believes that merger-mania helped erode America's international competitiveness in the 1980s.

The future of hostile takeovers in Japan is dim, whether domestic- or foreign-initiated. T. Boone Pickens' attempt to force the management of a Japanese automotive parts maker to change its business plans by dint of his status as the largest stockholder has confirmed the disruptive nature of M&A in the minds of most Japanese. This does not mean that friendly bids will be spurned. Although most M&A bids among domestic firms are seen initially as unfriendly from the seller's perspective, if the deal makes sense for both sides and the suitor is persistent as well as sincere, good business sense will at least force serious consideration of the overture. This is particularly true of smaller Japanese companies facing the same difficulties raising capital and competing in foreign markets (and at home) as many American firms encounter in Japan. These smaller firms are open to alliances that will expand access to overseas markets and that give them an edge over domestic competitors. Both foreigners and Japanese agree that it is more difficult to conduct a merger or an acquisition in Japan than in the United States. It is not, however, impossible; those firms that can adapt themselves to the Japanese way of doing business usually have been successful.

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The views expressed in this report are those of the author and do not necessarily represent those of the Japan Economic Institute.